

DOW THEORY LETTERS INC.

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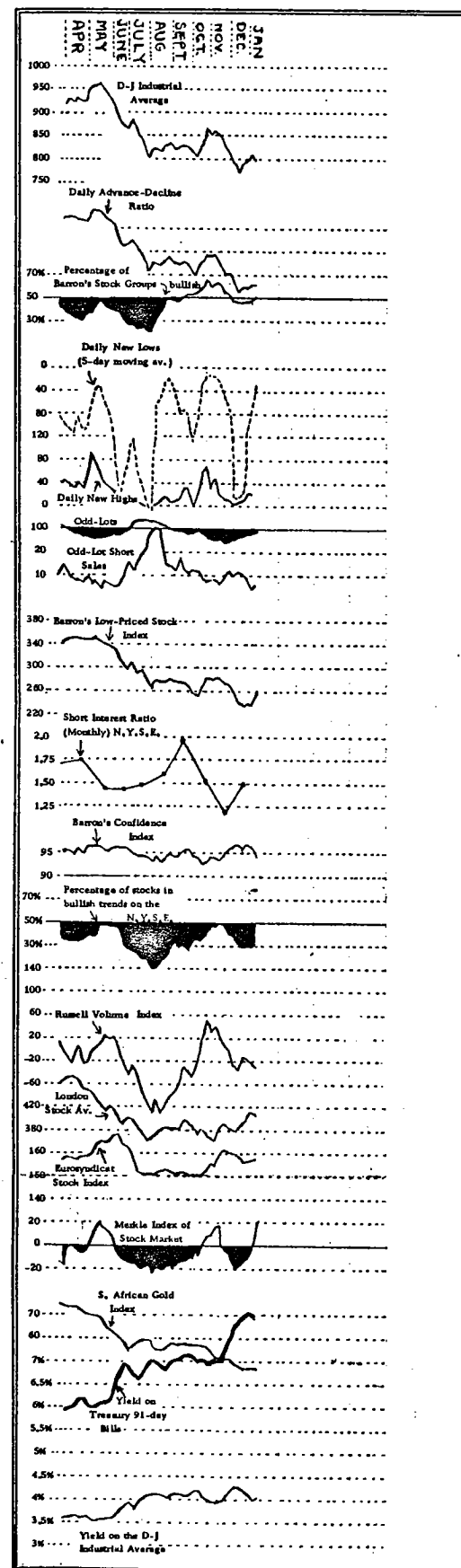
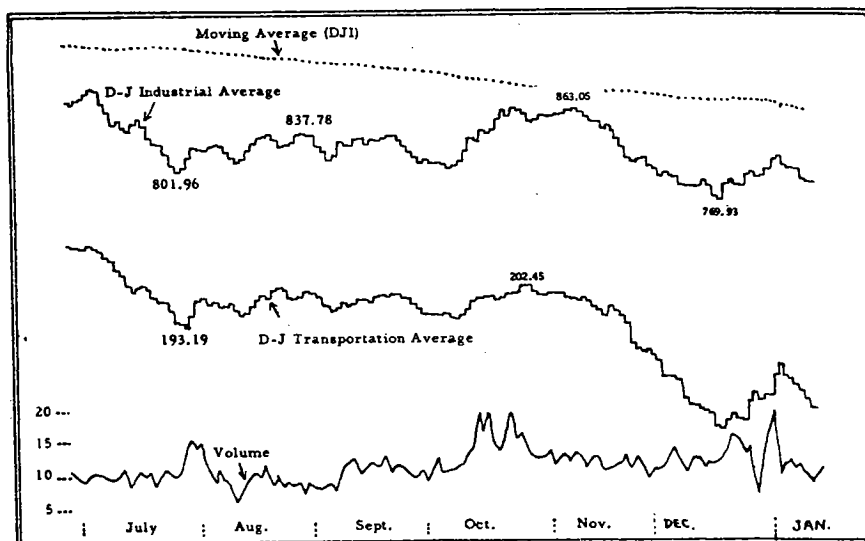
Letter 450

THE MARKET: "Tell me what the Fed is going to do, and I'll tell you what the market is going to do." Thus spoke a leading analyst in New York, and his sentiments have been echoed by the investment fraternity for months now. I sit here at my desk behind a pile of market services and publications, and I say to myself, "Russell, you're a contrary S.O.B. Why won't you believe what all the smart analysts are saying? Everyone 'knows' that tight money is driving this market down. Sooner or later business conditions will reflect what the Fed wants, and then the Fed will have to ease up. The market 'knows' this and will anticipate it. It will make a turn to the upside well before the Fed policy becomes apparent."

Ah yes, it's all so clear and logical. How can it fail to happen? Well, it may happen that way, and then again that old adage (often used by Robert Rhea) comes back to haunt me: "What everyone knows ceases to have any effect on the market." Then I say to myself, "Well, everyone knows that the Fed will have to ease up somewhere ahead, and everyone knows that when that happens the market will rally. Could everyone be missing something?"

It occurs to me that there is a thought that the analysts could be missing. Suppose the current market level has already discounted the inevitable easing up of money by the Fed? Suppose prices are as high as they are now because the market has already discounted a change in Fed policy. If that is possible, then when the actual news of the Fed's easing up comes out, the market will break on the downside. The good news of a turn to monetary ease will have already been discounted.

That is a discomforting thought. And then there's another thought which bothers me. Suppose the Fed doesn't do what everyone knows it will "have to do". Suppose the Fed continues its stand against continuing inflation regardless of what the stock market does. After all, the Fed is a little sick of everybody "knowing" what it has to do when the economy turns down. Could it be that this time they are going to take a firmer stand than ever before?



Page 2 Everytime there is a pause or sideways movement during a bear market it is human nature for everyone to ask whether "the bottom has been reached." Personally, I take a much longer view of the situation. If I see nothing to suggest that the primary bear market has truly expired, I simply ask myself whether an upward correction is in order or not. At present, I see no evidence that this bear market has discounted the "worst that may be seen ahead". Liquidation in the economy and the stock market have just started (although obviously the market is ahead of the economy). Public psychology is still highly bullish (see odd-lot short sales study in the last Letter). Business is still quite good, Wall Street is still much in favor, the possibility of a market smash is all but dismissed. None of these observations is suggestive of the termination of a primary bear market.

So the question on my mind is — are we in for a secondary (upward) correction? Even here (although the possibility cannot ever be dismissed) I am doubtful. The "year-end rally" was half-hearted. Selling came in early in January, indicating a continuing desire to swap stock certificates for cash. Forecasts for the market during early-1970 are complacent to optimistic. I get the "feeling" that very few people are really taking this bear market seriously.

So call the odds for a good rally here about 50/50. What does it matter? When we measure the risks against the possibility of rewards, the rally idea (in my opinion) becomes academic. From the standpoint of Dow's Theory, a primary bear market is in progress, and a century of data suggests the wisdom of avoiding the temptation to "beat" the primary trend. When the final bottom is reached I am sure I will not be writing in this vein. I will be urging and cajoling my subscribers in an effort to get them into the market. That hardly seems to be the problem facing Wall Street analysts today.

INTERNAL CONDITION: It might be valuable to start the New Year with a study of the internal condition of the market. The accompanying chart pictures the weekly closing for the D-J Industrials since January, 1968, together with three major "bullish percentage" indices.

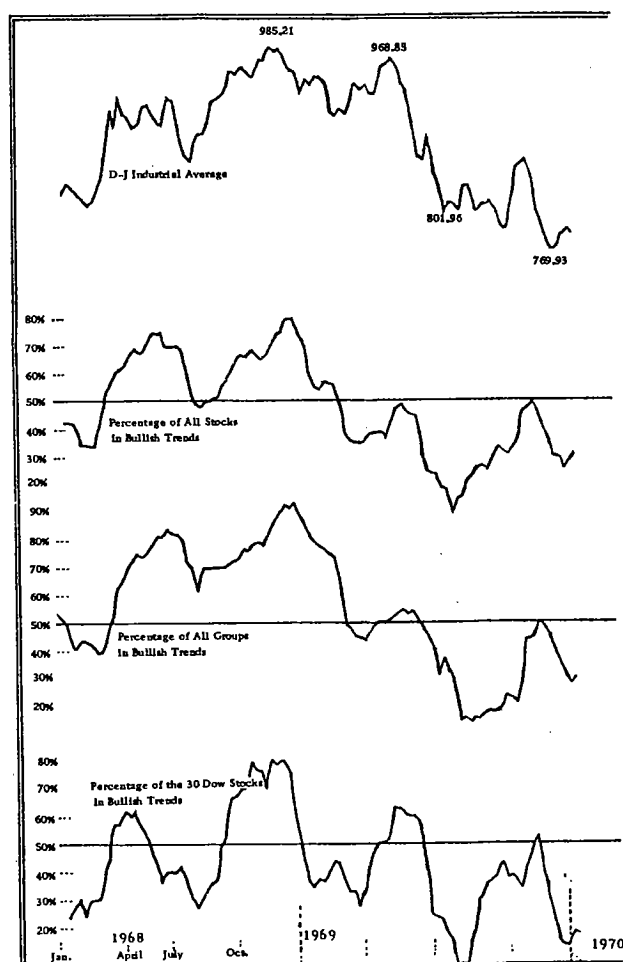
If one examines charts of all the stocks on the New York Stock Exchange, he will notice every conceivable type of formation. During a major decline, there will come a point in which an increasing number of stock simply stop going down. The next stage is a sideways movement in many stocks, and this is the period in which myriad bases are being formed. Then there will be a period in which one by one, individual stocks break upward from their bases, and the final stage will see the majority of stocks rising from their bases in a general upward movement by the market as a whole.

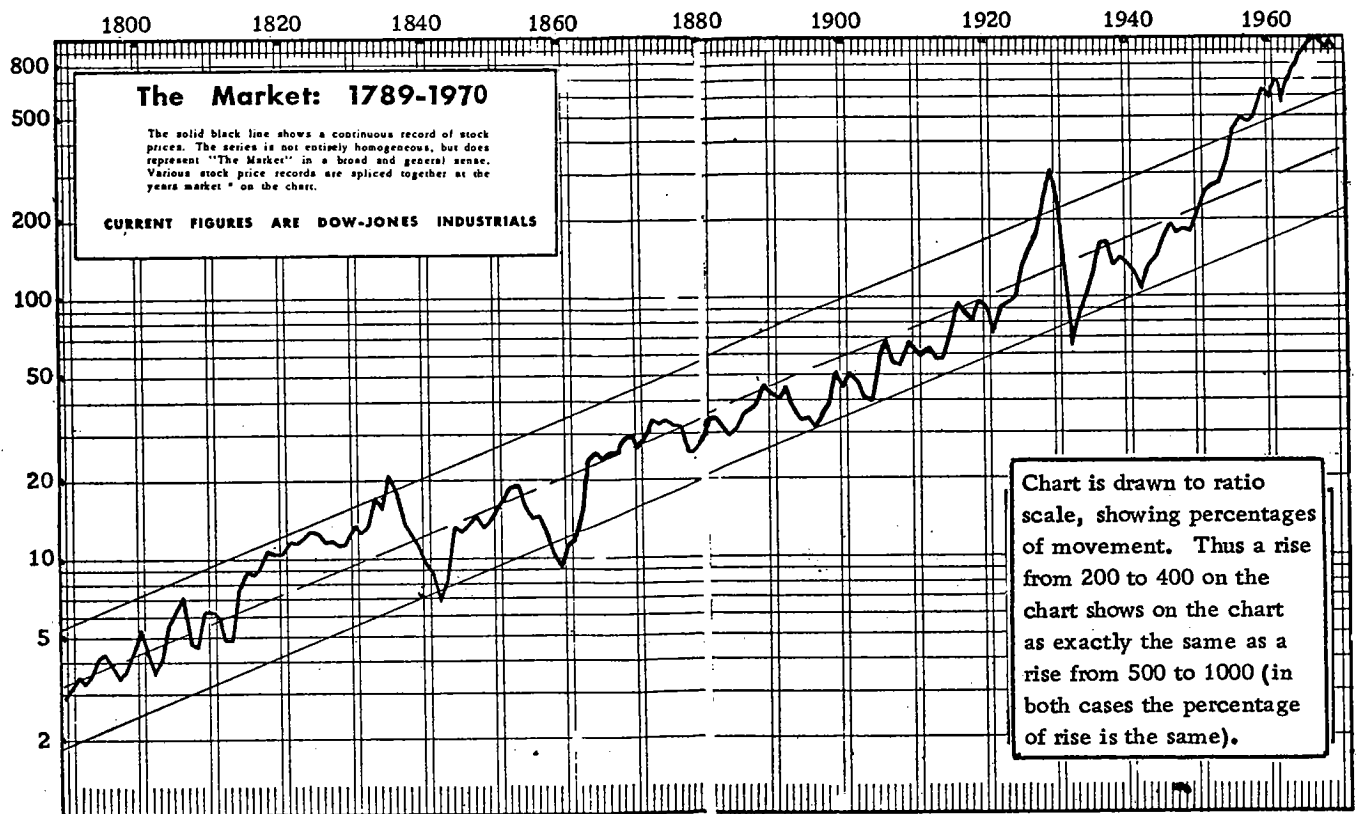
The weekly statistics which make up these indices are taken from Chartcraft point & figure tabulations (Chartcraft, Larchmont, N.Y.). In order for a bearish P & F chart to turn bullish, a rally must carry above a previous rally peak (in other words, a simple upward movement following a decline is not enough). Thus when a stock is listed as being in a bullish phase, there is a good chance that some sort of a base will have been formed.

The dividing percentage level on all three of these indices is the 50% level. In other words, when 50% of all stocks listed on the N.Y.S.E. or 50% of all stock groups or 50% of the 30 Dow stocks have turned bullish, it is usually a good sign. Most important rallies during bear markets will take all three indices above the 50% level. During bull markets, except in severe corrective phases, it is normal for these indices to remain above the 50% level (in primary bear markets the converse is true).

Note on the chart that since February, 1969, there was no period when all three of these indices were able to climb above the 50% level. During May the bullish percentage of all groups and the bullish percentage of the 30 Dow stocks did climb temporarily above the 50% level, but this action was not confirmed by the bullish percentage of all stocks. Subsequently, all three indices plunged below the critical 50% level, and they have remained there ever since.

As of this writing, the bullish percentages are as follows: 17% of the 30 Dow stocks are bullish, 31% of all stocks on the N.Y.S.E. are bullish, 30% of the stock groups are bullish. This is hardly a promising reading with which to start the New Year.





THE AMERICAN CHANNEL: I am starting off the New Year by publishing probably the longest index of American stock prices in existence. This chart was offered by Cycle Magazine some years ago, and I have kept it up to date ever since. I feel we can draw some interesting inferences from this chart.

The chart is drawn to "ratio" scale, and this means that it deals in percentages of advance or decline. Thus a theoretical fixed rate of growth would appear as a perfect ascending trendline on this ratio chart.

The chart traces the path of the most reliable stock indexes through 1896, and from 1896 on the D-J Industrial Average is used. Note that the entire movement since 1789 has been placed within a channel, and midway in the channel a centerline has been drawn. The centerline might be said to represent a theoretical "normal" average rate of growth.

Here are some interesting observations. Of the total 181 years of stock prices shown, only 25 years have seen the stock average either above or below the limits of the channel. This means that the stock average has held within the channel limits 86% of the time.

Of the 25 years in which the stock average has been outside the channel limits, 15 of those 25 years have occurred since 1955 (or during the past 15 years). This means that in the light of 181 years of market history, the last 15 have been extraordinary, or one might say that they are highly "abnormal". The question which arises is — what happens if historical "normality" returns to the market?

On February 9, 1966, a primary bear market began. It was the first primary bear market, following a major percentage rise in the average, since 1937 (see chart). After 4 years the bear market has succeeded in erasing only 251 points from the average. There is a strong possibility, however, that the next few years could see the bear market make up for lost time.

If this is correct, it would not be surprising to see the Dow touch or enter the channel again. If the Dow merely touches the upper channel limits during 1970, it could drop to the 600 area. If, before the bear market is over, the Dow touches the centerline of the channel, we could see it under the 400 level. Just for the record, there have only been four instances when the Dow touched the lower limits of the channel. They were 1842, 1859, 1896 and 1932. If some disaster were to send the Dow to the lower channel limits during 1970, we would see a figure of about 225 for the Industrial Average.

Channel") might well comment, "Why can't the Dow stay above the upper limits of the 1789 to 1970 channel forever? What makes Russell think the great decline is nearing?"

In answer I must return to a study which I have commented upon a few times in the past. The accompanying chart shows the high-low range of the Dow Industrials since 1922. This chart gives us a different perspective—and an ominous one. For here we see that since the historic low close of 92.92 in 1942, the Dow has held within an ascending channel for 27 years. But the year 1970 (as I had warned) is changing the picture drastically.

During 1968 the Dow barely penetrated the lower limits of the channel line. During 1969 the Dow fell well below the lower channel limits for the first time since 1942. At that time I warned readers that a massive turning of the tide was becoming visible. Now, as 1970 begins, the picture is beginning to look truly frightening. If there were any doubts as to a giant reversal in the "inflationary-growth" trend since 1942, the current picture would seem to dispel those doubts.

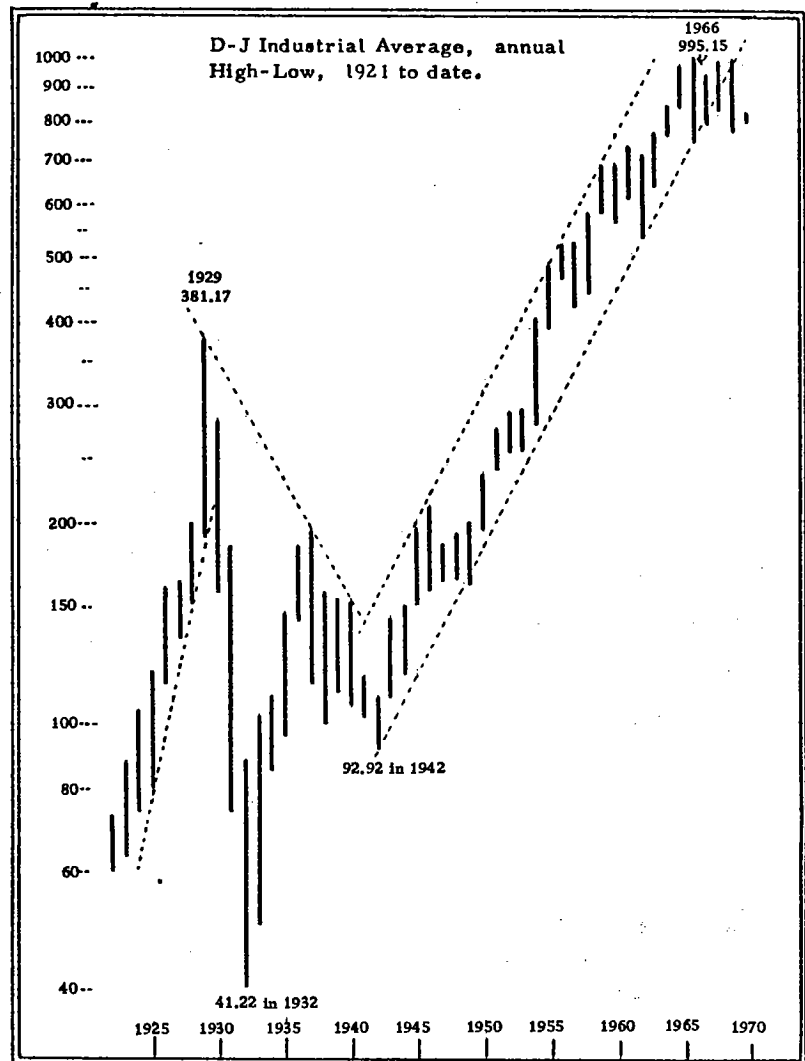
The Dow has opened the year 1970 fully 125 points under the lower limits of the channel. The low for the year 1969 on the Dow was 769.93 established December 17. On this chart any substantial decline which would take the Dow below the 1969 low would appear extremely bearish. Such a movement would bring up the following thoughts: (1) The

Industrial Average during 1969 broke out of the lower side of the channel; however, it could be argued that the movement was created by the passage of time, since if the 1969 range had been placed within the 1968 high-low range the picture would not have looked that bad. (2) But if, during 1970, the Dow sinks below the 1969 lower limit of 769.93, we can no longer blame the picture on the construction of the chart. A 1970 break below 769 will set a pattern (begun in 1968) of annual lows which are below the lows of the preceding year. This is what major primary bear market action looks like. It would be a warning that the tide has turned ominously bearish.

1970 AND LIQUIDITY: In the last few Letters I have been quoting any number of leading economists regarding the 1970 picture. There are the optimists and the pessimists, and they all have interesting things to say. But what interests me most is the "optimism" of the pessimists. The most bearish of them are talking about a recession of the 1960 type with an outside possibility of perhaps "something like 1957". Personally, I don't believe any forthcoming recession will be as harmless as 1957.

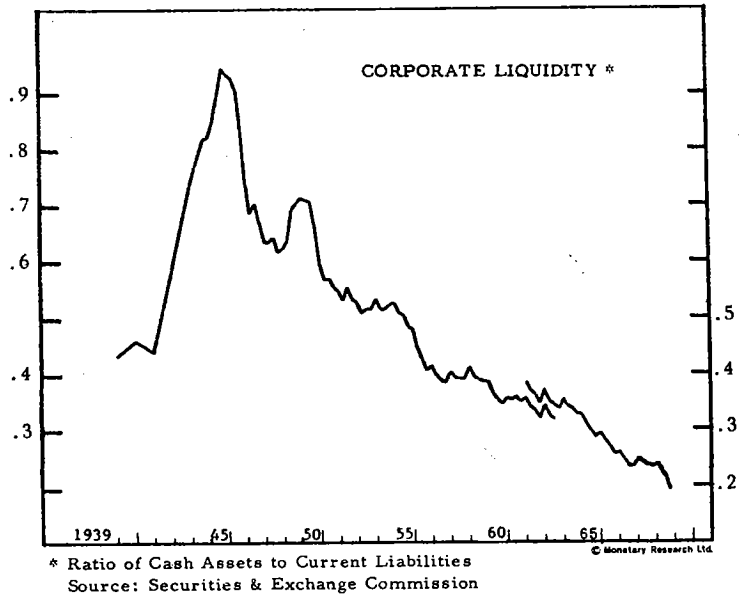
The reason is liquidity. In Letter 447 I included a chart by Irving Weiss showing the nation's three key financial institutions in terms of their "margin positions." The chart showed that all U.S. commercial banks, savings banks and S & L institutions (taken as a single unit) are now on the lowest margin since 1900. The margin Weiss is talking about consists of all bank deposits and savings against all bank loans. The chart indicated that bank margins are now at an historical low of 18%, which means that never have so many loans been outstanding in terms of bank deposits and savings.

This is a problem in liquidity. As the current issue of the Bank Credit Analyst takes pains to point out, there is a difference between a credit crisis and a liquidity crisis. To put it on a personal basis, if you require \$25,000 a year to live on, and you have \$100,000 in the banks and a job which pays you \$35,000 a year, you are in pretty good shape. If your salary, because of economic conditions, is cut to \$20,000—you may face a credit problem in a year or so, but you are liquid and in pretty good shape to withstand an economic storm.



Now suppose you have the same \$25,000 a year expenses and your \$35,000 salary is cut to \$20,000 a year but you only have \$5,000 in the bank. You are shortly going to face a liquidity problem. You do not have enough reserve to keep up your standard of living. You have only one quick alternative, you have to cut your living expenses and perhaps sell some of your possessions. That \$5,000 in the bank isn't enough to tide you over, and that \$20,000 salary a year isn't enough to keep you going. You will have to cut expenses and start building up cash reserves (i.e., getting liquid).

The current issue of the Bank Credit Analyst shows two charts, one of which I have taken the liberty of reproducing. The first chart shows that receivables, as a percentage of dollar of sales, among U.S. corporations has been rising since 1941. At present there are almost 2.4 dollars of receivables (cash owed) to every dollar of sales (against about 40¢ of receivables against every dollar of sales in 1940). In other words, corporations are having to extend more and more credit for every dollar of sales.



Now look at the accompanying chart. This chart shows corporate liquidity, or the ratio of quick cash assets to current liabilities. As seen on the chart, liquidity is now at extremely low levels. Corporations can't "grab" dollars quick enough in this sort of environment. When liquidity is this low, the only thing standing between a solvent corporation and a corporation in trouble is a high level of business. Let business fall off (along with sales and profits) and your debt, overhead and production costs will "eat you up alive." And that, as I see it, is what those economists who are talking about a mild recession or a 20% drop in profits in 1970 aren't visualizing.

Therefore, as I see it, a recession in 1970 or 1971 is going to bring on a liquidity crisis as shrinking corporate cash flow and profits force American business against the wall. The current low level of corporate liquidity allows for no margin in the advent of a recession. Contracting business, should it arrive during 1970 or thereafter, will bring on one of the maddest scrambles for cash (i.e., liquidity) ever seen in this country.

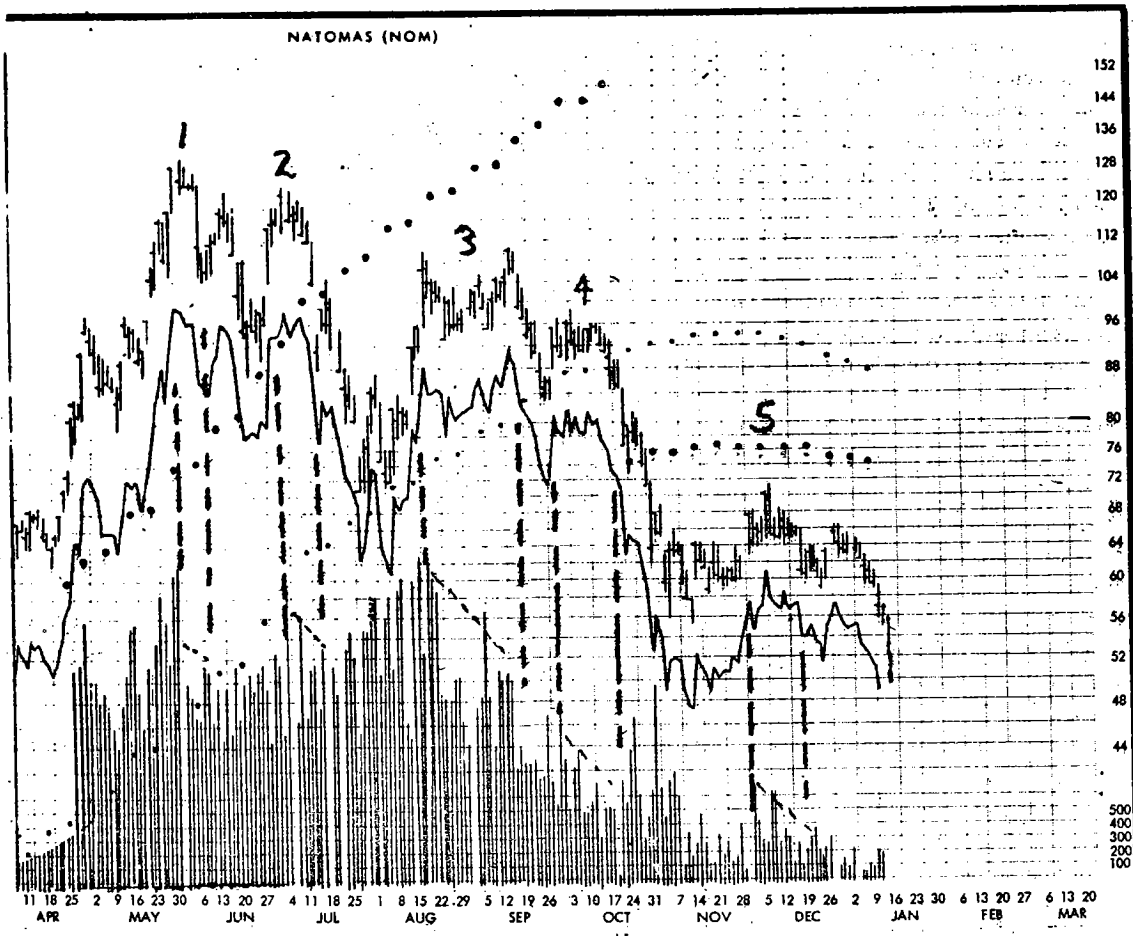
If that happens, interest rates are not going to ease as they "classically" do when the economy turns down. Interest rates, during the early stages of a liquidity crisis, are very apt to go to new highs. Which is something very few people today are thinking about.

THOUGHTS ABOUT STOCKS:

You may have heard the story about the broker who calls his client and says, "Charlie, I've got a sure one, Resourcology at 3. I've heard it's going through the roof." The client snaps, "Buy me a thousand at 3." An hour later the broker calls and shouts, "It's 7 now." The excited client says, "Buy me a thousand at 7." Next morning the broker calls to say "It's 15 at the opening." "Buy another thousand," snaps the client. That afternoon the broker calls to report that the price of Resourcology is 25. "Fantastic," croons the client, "Sell it all." There's a moment of silence, and the broker asks, "To whom?"

I couldn't help thinking of that sad story as I glanced at the daily chart of Natomas, a conglomerate with an oil kicker. NOM took off from a price of 5 in 1960, and by 1967 it was 22. It had not gathered a following, as judged by volume studies. In 1968 volume started coming in and NOM went into the high 30's. During early 1969 volume started pouring in as NOM hit a high of 130.

From here on we can watch NOM's progress (or distribution) on the chart on page 6. The first danger signal is marked 1 on the chart, and here we see volume dropping off as the high is reached. At the second lower peak (2) volume again tended to recede, indicating that the prior peak at 1 was not going to be surpassed. At 3 a double attempt to push up was made, and at the second peak volume dropped drastically. If there were any doubts as to the exit of NOM's followers, this should have dispelled those doubts.



At 4 volume sank drastically, and NOM went into a dive from 96 to 56. In late 1969 another rally brought in pathetic volume, and the stock headed down again. On January 14 NOM broke 50 on the downside, and that's where it stand today. Where are the enthusiasts of May who were paying 130 for NOM? Probably sitting on the sidelines with their profits. And if they didn't sell, if they're still holding their stock, they're probably asking themselves the old question posed by the broker in the joke, "Who do I sell it to?"

Moral: When a stock starts at 5 and is 130 nine years later, and it is bringing in heavy volume, you are probably buying into a distribution. When you are buying into a distribution during a primary bear market, you are compounding a financial mistake. That's why those who bought NOM at the 1969 high are now losing almost 70% of their money if they still hold the stock. (Chart of NOM courtesy of my friends at Traders Research, 101 Cherry St., Alton, Ill. 62002).

GOLDS: I have been advocating a 10% to 15% hedge position in gold shares. Hundreds of news subscribers have come in since my earlier recommendations, and I believe that they can now assume that hedge position too. I am hazarding the guess that gold shares are on their lows, that they have absorbed all the nonsense connected with 1969's propaganda regarding the U.S. Government finding a way to make paper substitute for the yellow metal. Governments have been trying to make promises and paper due for gold for the past 5,000 years. They have all failed. Government's can fool people for long periods of time regarding their ability to substitute paper for gold. In the end, gold always wins. Gold wins because ultimately men prefer something of value to promises that don't work and lies that fall apart.

I'm not going to go into the whole story now, the story of the S.D.R.'s, which are merely international paper, or any of the other facets of the picture. I am simply going to say that at these prices I like Dome Mines, Campbell Red Lake, Homestake, and (S. African) Western Deep Levels, President Brand, Free State Geduld, Pres. Steyn, Blyvoors. The chart of Dome, which I suspect shows a double bottom, is courtesy of Quote Digest.

